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IN THE

Supreme Court of the United States

October Term, 1968

No. 1352

FRANCIS T. NORMAN and
MARGUERITE M. NORMAN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

CHARLES J. McDONOUGH,
Attorney for Petitioners,
930 Walbridge Building,
Buffalo, New York 14202.

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FRANCIS T. NORMAN and
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Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The petitioners Francis T. Norman and Marguerite M. Norman pray that a writ of certiorari issue to review the two judgments and orders of the United States Court of Appeals for the Third Circuit, entered herein on February 26, 1969.

Opinion Below

The United States Court of Appeals, Third Circuit, wrote a *per curiam* opinion, a copy of which is appended hereto.

The Tax Court also wrote an opinion herein, a copy of which is appended hereto.

Grounds on which Jurisdiction is Invoked

On February 29, 1968, the Tax Court handed down its opinion, declaring income tax deficiencies and negligence penalties due from the petitioners for the calendar years 1958, 1959, 1960 and 1961. On May 16, 1968, decisions were entered, pursuant to said opinion.

On February 26, 1969, the United States Court of Appeals for the Third Circuit entered judgments affirming the decisions of the Tax Court.

Jurisdiction of this court is invoked under Title 28, United States Code, Section 1254(1).

Questions Presented for Review

The petitioners, husband and wife, filed joint returns. The petitioner Francis T. Norman embezzled funds of his employer which the courts below held to be current income in the years in which they were embezzled. Two questions are presented:

1. Were the illegally diverted cash receipts current income to the petitioners in each year, or did they in fact constitute loans or advances to Francis T. Norman, with respect to which there was a "consensual recognition, express or implied, of an obligation to repay - - -" by the parties? (*James v. United States,* 366 U. S. 213, 219.)

2. May the additional tax and penalties be assessed against the innocent wife of the embezzling taxpayer?

Constitutional and Statutory Provisions

Internal Revenue Code of 1954, Title 26, U. S. Code, Section 61(a)

"§ 61. *Gross income defined*

(a) *General definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

(b) - - -"

Idem Section 6653(a):

"6653. *Failure to pay tax.*

(a) *Negligence or intentional disregard of rules and regulations with respect to income or gift taxes.*— If any part of any underpayment (as defined in subsection (c) (1) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to de-

fraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(b) - - -''

United States Constitution, Amendment V:

"No person - - - shall - - - be deprived of life, liberty or property without due process of law; - - -''

Statement of the Case

From 1924 until October 29, 1962, the petitioner Francis T. Norman was Secretary-Treasurer of the Firch Baking Company, Erie, Pa. Among his duties were the collection and handling of daily cash receipts from a retail bakery owned and operated by Firch.

From 1958 through 1962, Norman diverted large amounts of the daily cash receipts from the Firch retail store, and deposited them in various bank accounts. None of the amounts were reported.

In order to conceal the taking of the money, Norman directed the entry of amounts in Firch's books and records which were less than the total amounts actually received by him from the retail store cash receipts.

In October 1962, Firch discovered that Norman had been diverting the cash receipts. Norman thereupon resigned, at Firch's request.

On October 27, 1962, Mr. and Mrs. Norman executed and delivered the "trust agreement'' (Exhibit H, Record), which authorized the First National Bank of Erie to assign and transfer to Firch, over a period of about five years, 527 shares of Firch stock which had been acquired by Norman during the years of his employment by that company. Under the terms of the agreement, the last assign-

ment of 100 shares to Firch by the bank was made on January 2, 1967 (Exhibit H).

As an integral part of the same settlement agreement, Norman also paid Firch $20,000.00 in cash (Exhibit G, Record).

On October 30, 1962, Norman and Firch executed the mutual release (Exhibit I), which provided:

> "Oct. 30, 1962. Upon receipt of valuable consideration, receipt of which is hereby acknowledged, each of the undersigned releases the other from all claims as any nature against the other arising out of the employment of F. T. Norman by the Firch Baking Company.
>
> F. T. Norman
> Firch Baking Co.
> by John R. Dwyer, Pres."

The respondent assessed large additional taxes and negligence penalties for each year, based upon the amounts of the diverted cash receipts which were deposited in the bank accounts each year; and declared an overpayment for 1962, in which repayment was made.

The petitioners contend that under the peculiar facts of this case, there was clearly a "consensual recognition, express or implied, of an obligation to repay - - -" by the parties. (*James v. United States, supra.*)

The Commissioner made no claim of implication or participation in the embezzlement by Mrs. Marguerite M. Norman.

The case was presented to the Tax Court on a stipulation of fact, a copy of which, with exhibits, is appended hereto.

Reasons for Granting the Writ

1

In *James v. United States* (*supra*), the court overruled its earlier decision in *Commissioner v. Wilcox,* 327 U. S. 404, and held that embezzled funds were ordinarily to be included in the gross income of the embezzler in the year of misappropriation.

However, no element of repayment or promise to repay was present in *James.* We believe this point is crucial for determination of the present case.

In *James,* the court pointed out (p. 219):

> "When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, 'he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.' North American Oil Consol. v. Burnet, *supra* (286 U. S. at p. 424). In such case, the taxpayer has 'actual command over the property taxed' the actual benefit for which the tax is paid. Corliss v. Bowers, 281 U. S. 376, 74 L. ed. 916, 50 S. Ct. 336, *supra.* This standard brings wrongful appropriations within the broad sweep of 'gross income'; it excludes loans."

Neither in *James v. United States,* nor in any of the cases relied upon by the courts below, had the taxpayer actually repaid the diverted funds before the income tax investigation.

In the case at bar, in October 1962, long before the income tax investigation began, Norman and Firch, by mutual consent, and in a formal contract, recognized Norman's

obligation to repay the diverted funds. The agreement was executed, by actual repayment.

In October 1962, the petitioner Francis T. Norman paid to Firch $20,000.00 cash, plus stock worth $92,225.00, a total repayment of $112,225.00. The diverted funds, as evidenced by bank deposits in the years involved, totalled $109,862.19. (Amended Petition, Commissioner's Schedule, Exhibit A.)

The mutual release executed by Norman and Firch constituted undeniable recognition of Norman's obligation to repay the money. Each party released the other "from all claims of any nature against the other arising out of the employment of F. T. Norman by the Firch Baking Company".

The intention of the parties to treat the transaction as the repayment of loans or advances is unmistakably clear, from the settlement documents. The court should give great weight to the intention of the parties, as evidenced by their actions and the documentary proof, made long before the tax investigation was begun.

In *James,* no point is made as to *when* the "consensual recognition, express or implied, of an obligation to repay - - -" must have come into existence.

Under *James* the recognition of the obligation to repay need not even be express. It may be implied.

Neither law nor logic demand that the mutual recognition of the obligation to repay must have sprung into being at the instant the receipts were diverted. Such a mutual agreement would, in fact, be impossible at that time. The employer could not then even know of the diversion.

The exact timing of the consensual recognition would therefore seem unimportant, so long as it occurs before the tax investigation begins, as in the present case.

This case presents an important question of law, implicit in *James,* but not yet decided by this court (Supreme Court Rule 19 (1) (b)).

2

The taxpayers filed joint returns for the years in question. However, there was neither claim nor proof that Mrs. Norman knowingly participated in or connived at her husband's embezzlement.

It is one thing to hold, in the ordinary case, that additional taxes may be assessed against both husband and wife, where a joint return has been filed. It is another to hold that an innocent wife's separate estate may be subjected to additional taxes and penalties assessed by reason of embezzlements by her husband, without proof that the wife either connived at or was a party to the embezzlements.

Mrs. Norman has been thereby deprived of her property without due process of law, in violation of her rights under the Fifth Amendment.

This presents another important question of federal law which has not been, but should be settled by this court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

CHARLES J. McDONOUGH,
Attorney for Petitioners,
930 Walbridge Building,
Buffalo, New York 14202.

Dated: April 8, 1969

Third Circuit Opinion

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17362

FRANCIS T. NORMAN and MARGUERITE M. NORMAN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 17491

FRANCIS T. NORMAN and MARGUERITE M. NORMAN,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant.

APPEALS FROM THE TAX COURT OF THE UNITED STATES

Argued February 7, 1969
Before HASTIE, *Chief Judge*, and GANEY and SEITZ, *Circuit Judges.*

OPINION OF THE COURT
(Filed February 26, 1969.)

PER CURIAM.

From 1958 through 1962, the taxpayer, Francis T. Norman,[1] wrongfully appropriated to his own use monies owed to his employer and collected by Norman as his employer's agent. In none of the taxable years did he report as income the amounts thus misappropriated. He is here challenging deficiencies and penalties which the tax court determined and assessed on the theory that the misappropriated funds were income to him.

On the facts stated above, without more, the decision of the tax court would be correct. Indeed, it would be required by *James v. United States*, 1961, 366 U. S. 213. However, the taxpayer relies upon the additional circumstances that in 1962, after his wrongdoing was discovered, he and his employer entered into a "trust agreement" designed to assure full repayment of the misappropriated sums over a period of five years and the employer released Norman from all other liability. It seems to be the taxpayer's theory that this arrangement gave the underlying misappropriations the status of loans.

In our view the 1962 agreement neither purported to nor could change the original legal character of Norman's earlier conduct from embezzlement to borrowing. Any restitution in a subsequent year might provide a proper basis for a deduction allowable in that year. Indeed, the tax court so treated the taxpayer's restitution and made an appropriate deduction in determining his 1962 tax liability. We find no error in the tax court's decision as to any year.

[1] Norman's wife, Marguerite, is a party solely because husband and wife filed joint income tax returns.

The Commissioner has filed a protective appeal from the 1962 tax determination to be considered only if the taxpayer's contentions as to the earlier years should be sustained.

On both appeals the tax court's decision will be affirmed.

Third Circuit Judgments of Affirmance

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17,362

FRANCIS T. NORMAN and MARGUERITE M. NORMAN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

(Tax Court Docket No. 1647-65.)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: HASTIE, *Chief Judge*, and GANEY and SEITZ, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:

THOMAS F. QUINN,
Clerk.

February 26, 1969.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17,491

FRANCIS T. NORMAN and MARGUERITE M. NORMAN,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellant.

(Tax Court Docket No. 1647-65.)
ON APPEAL FROM A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: HASTIE, *Chief Judge* and GANEY and SEITZ, *Circuit Judges.*

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:

THOMAS F. QUINN,
Clerk.

February 26, 1969.

Stipulation of Facts

Docket No. 1647-65.
Docket No. 6341-66.

It is hereby stipulated that, for the purpose of these cases, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part thereof; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. Petitioners are Francis T. and Marguerite M. Norman, husband and wife. They resided at 455 West Gore Boulevard, Erie, Pennsylvania on the date the petition herein was filed with the Court.

2. During the years 1958 through 1963, petitioners were on the cash basis.

3. Petitioners timely filed joint federal income tax returns (Forms 1040) for the taxable years 1958 through 1963, inclusive, with the District Director of Internal Reve-

nue at Pittsburgh, Pennsylvania. Copies of the returns are attached Exhibits 1-A through 6-F, respectively.

4. On March 7, 1964, petitioners executed a consent for the taxable year ending December 31, 1960, extending the statute of limitations upon assessment until December 31, 1964. The consent was accepted and executed on behalf of the respondent on March 23, 1964.

5. From 1924 until on or about October 29, 1962, petitioner-husband (hereafter called Norman) was employed as the Secretary-Treasurer of the Firch Baking Company, Erie, Pennsylvania (hereafter called Firch).

6. Norman's employment duties required that he physically handle and verify daily cash register receipts from a retail baked goods store owned and operated by Firch.

7. During the taxable years 1958 through 1962, Norman diverted the following amounts of the daily cash receipts from the Firch retail store to his own personal use and benefit:

1958	$17,550.29
1959	29,721.92
1960	22,505.58
1961	18,260.25
1962	21,824.15

Such cash receipts were deposited in petitioners' bank account accounts. None of the foregoing amounts were reported by the petitioners on their joint federal income tax returns filed for such years.

8. During the taxable year 1963 petitioners deposited the amount of $2,713.85 in their checking account at the First National Bank of Erie, as shown in the notice of deficiency. Said amount was accumulated from cash re-

ceipts that were diverted by Norman from Firch's retail store during the taxable year 1962, prior to the termination of his employment. Norman retained said cash in his possession until it was deposited. Petitioners did not report said amount in their income tax returns filed for either the taxable year 1962 or 1963.

9. The foregoing amounts were expended by petitioners for their own personal purposes and benefit.

10. Norman did not make or maintain at any time, any records or memoranda concerning the amounts that he diverted from the cash receipts of the Firch retail store. The only records of such amounts are the banks' records pertaining to deposits thereof in petitioners' bank accounts.

11. In order to conceal his taking of cash receipts, Norman directed the entry of amounts in Firch's books and records that were less than the total amounts actually received by him from the retail store cash receipts.

12. Norman's diversion of cash receipts from Firch's retail store occurred without the consent or knowledge of any other employee or officer of Firch. No contemporaneous notes or agreements with respect thereto were executed.

13. In October 1962, Firch discovered that Norman had been diverting cash receipts as aforesaid. Consequently, Norman's services were terminated by resignation requested by Firch.

14. In satisfaction of the claim of Firch against Norman for his wrongful diversion of cash receipts, Norman paid $20,000.00 to Firch on October 29, 1962, by his check, a copy of which is attached as Exhibit G, and transferred

527 shares of stock to the First National Bank of Erie pursuant to the provisions of a trust agreement executed by Norman, a copy of which is attached as Exhibit H. The petitioners' cost basis in said stock was $100.00 per share and its value at the time of transfer was $175.00 per share. Petitioners had held such stock more than six months. On October 30, 1962, Firch and Norman also executed a document, a copy of which is attached as Exhibit I, as a part of the transaction.

15. The amounts of cash receipts that were wrongfully diverted by Norman from Firch's retail store for the taxable years involved in these proceedings were determined by the respondent under the bank deposits method, as set forth in the notices of deficiency.

16. Petitioners concede that all adjustments set forth in the notices of deficiency are correct, except adjustments (a), relating to additional income for each of the respective taxable years; adjustment (b), relating to capital gains for the taxable year 1962; and, the medical expense adjustments.

17. The parties agree that a recomputation of the amount of allowable medical expense deduction for the taxable year 1962, will be necessary to take into consideration the Court's determination of the contested issues in this case.

(Signed) CHARLES J. McDONOUGH,
Counsel for Petitioners,

(Signed) LESTER R. URETZ,
DWH
Chief Counsel, Internal Revenue Service.

EXHIBIT C (check)

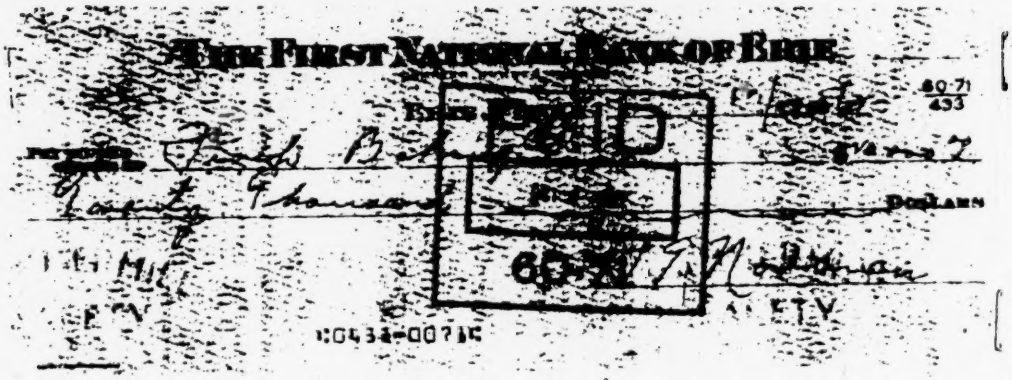


EXHIBIT H (TRUST AGREEMENT).

Trust Agreement.

I, Francis T. Norman, sometimes known as F. T. Norman, hereby give all my common stock of the Firch Baking Co., amounting to 527 shares, to the First National Bank of Erie, in trust for the following:

1. To hold said stock and to vote and administer same.
2. To receive and pay over all the net income received in the trust to me and/or my wife Marguerite M. Norman.
3. To turn over to the Firch Baking Co. 27 shares of said stock on Oct. 29, 1962 and 100 shares on Jan. 2, 1963, and 100 shares on the 2nd day of January of each year thereafter until all stock is so turned over, at which time said trust will terminate.
4. I hereby authorize said trustee to sell any or all of said stock in the trust, provided consent in writing is received by the trustee from the Firch Baking Co.
5. I give up all my rights in said stock to said trustee immediately, except the right to receive any net income therefrom as per above.
6. In the event any of said stock is sold, the proceeds shall be immediately payable to Firch Baking Co.
7. This trust is irrevocable.

Dated at Erie, Pa., this 27th day of October, 1962.

F. T. NORMAN,
FRANCIS T. NORMAN.

Witness
J. B. DWYER

EXHIBIT I (RELEASE).

Oct. 30, 1962. Upon receipt of valuable consideration, receipt of which is hereby acknowledged, each of the undersigned releases the other from all claims of any nature against the other arising out of the employment of F. T. Norman by the Firch-Baking Co.

F. T. NORMAN,
FIRCH BAKING CO.,

by JOHN R. DWYER,
Pres.

Attest:
JAMES B. DWYER,
Secy.

Tax Court Memorandum Opinion

Docket Nos. 1647-65, 6341-66.

Charles J. McDonough, for petitioners.
John W. Tissue, for respondent.

Filed February 29, 1968.

ATKINS, *Judge:* In Docket No. 1647-65 the respondent determined tax deficiencies of $9,686.79, $17,137.57, $12,919.11, $10,059.11, and $18,163.65 against the petitioners for the taxable years 1958, 1959, 1960, 1961, and 1962, respectively, and additions to tax thereon under section 6653(a) of the Internal Revenue Code of 1954 in the respective amounts of $484.34, $856.88, $645.96, $502.96, and $908.18. In Docket No. 6341-66 he determined an income tax deficiency of $490.78 against the petitioners for the

taxable year 1963 and an addition to tax thereon under section 6653(a) in the amount of $24.54.

The issues presented are whether cash receipts illegally diverted by the petitioner Francis T. Norman from his employer constituted gross income in the years of the diversions; whether the petitioners realized capital gain in the taxable year 1962 as a result of their transfer of stock in that year in partial satisfaction of the employer's claim for restitution of the amounts wrongfully diverted; and whether the petitioners are liable for additions to the tax under section 6653(a) of the Code.

All of the facts have been stipulated and the stipulations are incorporated herein by this reference.

The petitioners, husband and wife, filed joint Federal income tax returns on the cash method of accounting for the taxable years involved with the district director of internal revenue, Pittsburgh, Pennsylvania. On the date the petitions herein were filed the petitioners' residence was in Erie, Pennsylvania. Hereinafter Francis T. Norman will be referred to as the petitioner.

From 1924 until October 1962, the petitioner was employed as the secretary-treasurer of the Firch Baking Company, Erie, Pennsylvania, a corporation, hereinafter referred to as Firch. His duties included the handling and verification of daily cash register receipts from a retail baked goods store owned and operated by Firch. During the taxable years 1958 through 1962 the petitioner diverted to his personal use and benefit the following amounts of daily cash receipts from the Firch retail store:

1958	$17,550.29
1959	29,721.92
1960	22,505.58
1961	18,260.25
1962	24,538.00

The above cash receipts were deposited in the petitioners' bank accounts and were expended by the petitioners for their own personal purposes and benefit. The foregoing amounts were not reported by the petitioners on their returns filed for the taxable years 1958 through 1962. Of the amount diverted in 1962, $2,713.85 remained in the petitioner's possession until 1963, when it was deposited in the petitioners' checking account. The petitioners did not report the $2,713.85 in their return filed for the taxable year 1963. The petitioner did not make or maintain at any time records or memoranda concerning the amounts that he diverted from the cash receipts of the Firch retail store. The only records of such amounts are the bank records pertaining to deposits thereof in the petitioners' bank accounts.[1]

In order to conceal his diversions the petitioner directed the entry in Firch's books and records of cash receipts of the retail store in lesser amounts than the actual cash receipts of the store. His diversion of cash receipts from the store occurred without the consent or knowledge of any other employee or officer of Firch. No contemporaneous notes or agreements with respect thereto were executed.

In October 1962, Firch discovered that petitioner had been diverting cash receipts from the store. Consequently, petitioner's services were terminated by resignation requested by Firch. In satisfaction of the claim of Firch against petitioner for his wrongful diversion of cash receipts, the petitioner in late October 1962 paid Firch $20,000 by check and transferred irrevocably 527 shares of Firch stock to the First National Bank of Erie, as trustee. The trustee was required to turn over 27 shares of the stock

[1] It has been stipulated that the "amounts of cash receipts that were wrongfully diverted * * * were determined by the respondent under the bank deposits method."

to Firch on October 29, 1962, 100 shares on January 2, 1963, and 100 shares on January 2 of each succeeding year until all of the stock was turned over to Firch, at which time the trust was to terminate. Under the trust agreement the petitioner gave up all his rights in the stock, except the right to receive all net income from the stock held in the trust during its existence. The trustee was authorized to sell any of the stock in the trust, provided written consent to such sale was given by Firch, in which case the proceeds of sale were to be paid immediately to Firch. On October 30, 1962, the petitioner and Firch, as a part of the same transaction, executed an agreement reciting that for consideration the parties released each other from all claims of any nature arising out of the employment of petitioner by Firch.

The petitioners' cost basis in the above stock was $100 per share and its fair market value at the time of transfer was $175 per share. The petitioners had held such stock more than 6 months.

In determining the deficiencies the respondent increased the petitioners' reported taxable income for the taxable years 1958 through 1962 by adding thereto cash receipts diverted by the petitioner from the Firch retail store as follows:

1958	$17,550.29
1959	29,721.92
1960	22,505.58
1961	18,260.25
1962	21,824.15

In addition, the respondent determined that for the taxable year 1962 the petitioners realized long-term capital gain of $39,525 on the transfer of 527 shares of Firch stock in that year; and therefore increased reported taxable income by $19,762.50. The respondent also determined additions to

tax for each of the taxable years 1958 through 1962 under section 6653(a) of the Internal Revenue Code of 1954 on account of negligence or intentional disregard of rules and regulations.

The respondent increased the petitioners' reported taxable income for the taxable year 1963 by adding thereto cash receipts diverted by petitioner from Firch in the amount of $2,713.85. He also determined an addition to tax for that year under section 6653(a) of the Code. It has been stipulated that the $2,713.85 added to the petitioners' taxable income for the taxable year 1963 represents amounts diverted by petitioner from Firch during the petitioners' taxable year 1962.

The respondent relies principally upon *James v. United States,* 366 U. S. 213, in support of his determination that the funds wrongfully diverted constituted taxable income to the petitioners in the years in question. In that case the Supreme Court overruled its prior decision in *Commissioner v. Wilcox,* 327 U. S. 404, and held that amounts embezzled by an employee from his employer constituted gross income to the employee, under section 61(a) of the Internal Revenue Code of 1954, in the year of embezzlement. The Court there stated in part:

> "When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, 'he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.' North American Oil v. Burnet, *supra,* at p. 424. In such case, the taxpayer has 'actual command over the property taxed—the actual benefit for which the tax is paid.' Corliss v. Bowers, *supra.* This standard brings wrongful appropriations within the broad sweep of 'gross income'; it excludes loans. * * *"

And it has been held that the principle of the *James* case is applicable to years prior to the decision in that case. *Estate of Wallace P. Geiger* (C. A. 8) 352 F. 2d 221, affirming a Memorandum Opinion of this Court, certiorari denied 382 U. S. 1012; and *Marvin E. Nerem*, 41 T. C. 338.

The petitioners contend that the principle of the *James* case is not applicable here. It is their contention that in view of the fact that in 1962 the petitioner made provision for satisfaction of Firch's claim against the petitioner for the diverted funds and the fact that petitioner and Firch entered into an agreement releasing each other from all claims of any nature arising out of petitioner's employment, it must be considered that there was a "consensual recognition, express or implied of an obligation to repay," and that the amounts diverted by the petitioner should be considered as amounts loaned or advanced. They state that the intention of the parties to treat the settlement as the repayment of loans or advances is unmistakably clear from the settlement documents.

We cannot agree with the petitioners. At the time the funds were diverted there was no knowledge on the part of the employer of the diversions, and no contemporaneous notes or agreements were executed with respect to the diverted receipts. Indeed, the petitioner deliberately concealed the diversions by falsification of the employer's records. Under these circumstances there could not possibly have been any express or implied consent on the part of the employer to the diversions. The stipulation refers to funds as "wrongfully diverted," and the petitioners refer to them on brief as illegal diversions. We must conclude that the diversions did not constitute loans or advances.

In the case of *L. M. Muldrow*, 38 T. C. 907, we rejected a contention similar to that raised by the petitioners here, stating:

> "During the taxable year petitioner sold for his own account 812 bales of embezzled cotton, for which he received likewise as his own $137,642.12. He deposited these funds in his personal bank account and had unrestricted use of them throughout the taxable year and, to the extent not previously lost or dissipated, during 1956 and 1957 and in 1958 at least until the time his defalcations were discovered. There is no showing of any recognition, consensual or otherwise, of an obligation to pay over any of the funds to the rightful owners of the cotton or of any holding of the funds for them until after his misdeeds caught up with him in 1958. And, under the *James* case, any such belated acknowledgement of liability may not be related back to the year of conversion, and that regardless of whether the taxpayer used an accrual or cash method of accounting in reporting his income."

We accordingly hold that the diverted receipts are includable in the petitioners' gross income in the taxable years in which the diversions occurred. The parties have stipulated that the $2,713.85 which the respondent included in the petitioners' income for the taxable year 1963 represented diversions made in the taxable year 1962.

Although the petitioners, in their petition, questioned the respondent's determination that they were in receipt of long-term capital gain in the taxable year 1962 upon the disposition of the 527 shares of stock in satisfaction of the petitioner's liability for his diversions, this subject is not dealt with by them on brief. Suffice it to say that it is well established that the transfer of assets in satisfaction of an obligation is equivalent to a sale upon which gain or loss is recognized. See *Harry L. Bialock,* 35 T. C. 649, and cases cited therein. We accordingly approve the respondent's determination in this respect.

On brief the respondent states that if we find that the payment of $20,000 to Firch and the transfer of the 527 shares of stock in trust for the benefit of Firch was a re-

payment of the amounts which had been embezzled in the taxable years 1958 through 1962 "then it appears that the petitioners may be entitled to a deduction in 1962 under section 165(a) of the Code, for the repayment of embezzled funds. See Rev. Rul. 65-254, C. B. 1965-2 50."[2] In the instant case we are unable to conclude whether the diversions constituted embezzlement, or some other form of wrongful taking. There is no showing whether the petitioner was charged with, or convicted of, embezzlement. However, for present purposes we think it would be immaterial whether there was technically an embezzlement, and we construe the respondent's statement as a concession that the petitioners are entitled to a deduction for 1962 if we sustain his contention that the diverted funds did not constitute amounts loaned, but constituted taxable income in the years in which diverted. Accordingly, in the recomputation under Rule 50 the petitioners will be allowed a deduction for the taxable year 1962 in the amount of $112,225, consisting of the amount of cash paid, $20,000, plus the fair market value of the stock transferred in trust, $92,225.

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[2] Rev. Rul. 65-254 dealt with an employee who had embezzled funds from his employer in the years 1959 through 1961, and had repaid the amount embezzled when the embezzlement was discovered in 1962. It was there held that each of the several acts of embezzlement falls within the ambit of section 165(c)(2) of the Code, which provides for the deduction of "losses incurred in any transaction entered into for profit, though not connected with a trade or business." The Rev. Rul. accordingly held that a deduction is allowable under section 165(a) of the Code for the repayment of the embezzled funds for the taxable year in which the repayment is made.

It is of interest to note that the respondent's concession here is consistent with the position taken by the Government in *James v. United States*, 366 U. S. 213, as evidenced by the following statement in the opinion in the *James* case:

> When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as "gross income" in the year received. United States v. Lewis, *supra;* Healy v. Commissioner, *supra.* We do not believe that Congress intended to treat a law-breaking taxpayer differently. Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that, "if, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a reduction in the embezzler's income."

The respondent on brief has in effect conceded error in his determination of an addition to tax under section 6653(a) of the Code for the taxable year 1963.[3] The burden of proof is upon the petitioners to show that the respondent was in error in determining that they are liable for the additions to tax for the other years in issue. *Byron H. Farwell,* 35 T. C. 454, and cases cited therein. They have failed to meet such burden. The only reason advanced by them in support of their contention that the respondent erred in determining additions to tax under section 6653(a) is that the diverted funds constituted loans and not gross income to them. Since, as held above, the diversions constituted taxable income, we hold that they are liable for additions to tax under section 6653(a) of the Code to the extent provided in such section.

Decisions will be entered under Rule 50.

Decision

Docket No. 1647-65.

Pursuant to the opinion of the Court filed February 29, 1968, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes and additions to the tax due from the petitioners as follows:

[3] Sec. 6653(a) of the Code provides in part as follows:

(a) Negligence or Intentional Disregard of Rules and Regulations with Respect to Income or Gift Taxes.—If any part of any underpayment * * * is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

Year	Deficiency: Income Tax	Deficiency: Additions to the Tax, Section 6653(a), 1954 Code
1958	$ 9,686.79	$484.34
1959	17,137.57	856.88
1960	12,919.11	645.96
1961	10,059.11	502.96

and

That there is an overpayment in income tax for the taxable year 1962 in the amount of $1,827.00, which amount was paid on April 15, 1963, and for which amount a claim for refund could have been filed, under the provisions of section 6511(b)(2) of the Internal Revenue Code of 1954, on December 31, 1964, the date of mailing of the notice of deficiency.

(Signed) CRAIG S. ATKINS,
Judge.

(SEAL)

Entered: May 16, 1968.

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

CHARLES J. McDONOUGH,
Counsel for Petitioners.

(Signed) LESTER R. URETZ,
G. B.

(SEAL)

Chief Counsel,
Internal Revenue Service.

Decision

Docket No. 6341-66.

Pursuant to the opinion of the Court filed February 29, 1968, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1963 in the amount of $24.73; and

That there is no addition to the tax due from the petitioners for the taxable year 1963, under the provisions of section 6653(a) of the Internal Revenue Code of 1954.

(Signed) CRAIG S. ATKINS,
Judge.

(SEAL)

Entered: May 16, 1968.

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

(Signed) CHARLES J. McDONOUGH,
Counsel for Petitioners.

(Signed) LESTER R. URETZ,
G. B.
Chief Counsel, Internal Revenue Service.

(SEAL)